

agrees to maintain a minimum, average, or compensating balance.

(4) *Predecessor*. For purposes of this section, the term *predecessor* means (i) any taxpayer which transferred more than 50 percent of the total amount of its assets to the taxpayer and is described in § 1.585-1, or (ii) any predecessor of such predecessor.

(5) *Authorization years*. For purposes of this section, the term *authorization years* means the number of years, containing 12 complete months, between (i) the first day of the first full taxable year of the taxpayer for which it (or any predecessor) was authorized to do business as a financial institution described in § 1.585-1, and (ii) the taxable year.

(6) *Comparison years*. For purposes of this section, the term *comparison years* means those consecutive taxable years containing 12 complete months of a comparable bank, the last of which ends within 12 months immediately preceding the beginning of the first taxable year of the taxpayer, which are equal in number to six minus the number of authorization years of the taxpayer.

(7) *Comparable bank*. For purposes of this section, the term *comparable bank* means all the financial institutions described in § 1.585-1 located within the same Federal Reserve district.

(8) *Average loans outstanding*. For purposes of this section, the term *average loans outstanding* means the sum of the loans outstanding at the close of each taxable year of a period divided by the number of taxable years in such period.

(9) *Adjusted for recoveries of bad debts*. For purposes of this section, the term *adjusted for recoveries of bad debts* means an adjustment for the full amount recovered with respect to bad debts previously charged to the reserve during any of the applicable taxable years.

(Sec. 585(b)(4), of the Internal Revenue Code of 1954 (83 Stat. 618; (26 U.S.C. 585(b)(4))))

[T.D. 7532, 43 FR 3109, Jan. 23, 1978, as amended by T.D. 7835, 47 FR 42342, Sept. 27, 1982; T.D. 8513, 58 FR 68757, Dec. 29, 1993]

§ 1.585-3 Special rules.

(a) *Treatment of reserve*. For taxable years beginning after July 11, 1969, if a financial institution to which section

585 and § 1.585-1 apply establishes a reserve pursuant to section 585(a) (or, for taxable years beginning before January 1, 1987, section 166(c)), any bad debt in respect of a loan (whether or not such loan is an eligible loan) must be charged to the reserve for losses on loans provided for by § 1.585-1 for the taxable year in which the bad debt occurs. For such a year, any recovery of a bad debt previously charged to the reserve account in respect of a loan (whether or not such loan is an eligible loan) must be credited to such reserve in the taxable year of recovery regardless of whether such credit causes the reserve to exceed the permissible amount. If, as a result of net recoveries during the taxable year, the reserve balance exceeds the permissible amount, a taxpayer is not required to report the excess as taxable income. In such a case, the excess over the otherwise permissible amount in the reserve account precludes current reasonable additions to the reserve and may affect future reasonable additions. Recoveries of bad debts which were not charged to the reserve shall not be credited to such reserve, but shall be treated as taxable income subject to the provisions of section 111. No item other than a loan as defined in § 1.585-2 (e)(2) shall be charged to the reserve for losses on loans.

(b) *Accounting for reserve*. A financial institution to which section 585 and § 1.585-1 apply which establishes a reserve pursuant to section 585(a) (or, for taxable years beginning before January 1, 1987, section 166(c)) shall establish and maintain a permanent record of such reserve. Copies of Federal income tax returns and amended returns with attached schedules satisfy the requirements of this paragraph provided that such returns are permanently maintained by the financial institution and the balance of the reserve for losses on loans established pursuant to section 585(a) (or former section 166(c)) can be readily reconciled with the reserve for losses on loans maintained by the financial institution for financial statement purposes. The requirements of this paragraph would also be satisfied if a financial institution establishes and maintains a permanent subsidiary

ledger reflecting an account for the reserve for losses on loans established pursuant to section 585(a) (or former section 166(c)) provided the balance in such account can be readily reconciled with the balance of the reserve for losses on loans for financial statement purposes maintained in any other ledger. The permanent records maintained pursuant to this section must reflect any changes in the amount initially added to the reserve for losses on loans and the amount finally determined by the taxpayer to be a reasonable addition to the reserve for losses on loans.

(Sec. 585(b)(4), of the Internal Revenue Code of 1954 (83 Stat. 618; (26 U.S.C. 585(b)(4))))

[T.D. 7532, 43 FR 3114, Jan. 23, 1978, as amended by T.D. 8513, 58 FR 68757, Dec. 29, 1993]

§ 1.585-4 Reorganizations and asset acquisitions.

(a) *In general.* In computing a reasonable addition to the reserve for losses on loans for the first taxable year ending after a transaction to which section 381(a) applies and for subsequent taxable years, the separate reserves for losses on loans, the amount of loans outstanding, the total bad debts sustained (adjusted for recoveries), and the amount of eligible loans outstanding of the distributor or transferor corporation and the acquiring corporation (or, in the case of a consolidation, the transferor corporations) shall be combined for all applicable years. Thus, for example, in applying § 1.585-2(c)(1)(i) for the first taxable year ending after the distribution or transfer, the total bad debts sustained during the 5 preceding taxable years are the sum of the bad debts sustained by the acquiring corporation for the 5 preceding taxable years and bad debts sustained by the distributor or transferor corporation for the taxable year ending on the date of distribution or transfer and the 4 preceding taxable years.

(b) *Base year and base year amounts of acquiring corporation—*(1) *Base year.* For transactions to which section 381(a) applies, the base year of the acquiring corporation for the first taxable year ending after the date of distribution or transfer shall be the last taxable year ending on or before the date of dis-

tribution or transfer. The balance of the reserve, the amount of loans outstanding, and the amount of eligible loans outstanding at the close of such base year shall be determined in accordance with the provisions of subparagraph (2)(i) of this paragraph. For taxable years subsequent to the first taxable year ending after the date of distribution or transfer, the base year of the acquiring corporation shall be the more recent of the base year provided by the first sentence of this subparagraph or the base year provided by § 1.585-2(e)(1). If § 1.585-2(e)(1) provides the more recent base year, the balance of the reserve for losses on loans, the amount of loans outstanding, and the amount of eligible loans outstanding shall be determined at the close of such base year without regard to this paragraph.

(2) *Base year amounts—*(i) *Method of determination.* The balance of the reserve for losses on loans, the amount of loans outstanding, and the amount of eligible loans outstanding at the close of the base year provided by the first sentence of subparagraph (1) of this paragraph shall be the total of such amounts of the distributor or transferor corporation and the acquiring corporation (or, in the case of a consolidation, the transferor corporations) at the close of what would have been their respective base years determined under § 1.585-2(e)(1) if the distribution or transfer to which section 381(a) applies had not occurred, except that the method (experience or percentage) used or adopted by the acquiring corporation to determine its reasonable addition to a reserve for losses on loans for the first taxable year ending after the date of the distribution or transfer shall be considered to be the method that the distributor or transferor corporation (or, in the case of a consolidation, that the transferor corporation) would have used or adopted for its first taxable year ending after the date of distribution or transfer if the distribution or transfer had not occurred.

(ii) *Examples.* The application of the rule provided by this subparagraph may be illustrated by the following examples:

Example 1. The X Corporation and the Y Corporation are commercial banks both of